R5650-2

JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

NO. 34A September 6, 1985

JAPAN'S POLICIES FOR DECLINING INDUSTRIES: AN OVERVIEW

Summary

The rising number of financially troubled industries in the United States has rekindled American interest in Tokyo's adjustment policies for declining industries. These policies are designed to assist industries that can no longer compete internationally because of high input costs to regain competitiveness or at least viability, primarily by shedding excess capacity and forming business tie-ups in such areas as production and sales. The capacity-reduction part of the process, now in its eighth year, has produced results that are mixed at best. It has helped stabilize market conditions for some basic materials industries while not slowing the slide of others. This has led to a new debate in Japan about the effectiveness of government intervention in the adjustment process.

Managing the Adjustment of Declining Industries

The two oil crises of the 1970s, the steep run-up in prices of other industrial inputs and rising labor costs have permanently blunted the international competitive edge of a long list of products manufactured by Japan's chemicals, paper, textiles, steel, nonferrous metals and other basic materials industries. These same forces have also altered the production economics of many basic materials industries in the United States, confronting Washington as well as Tokyo with the question of whether government should assist sunset industries in adjusting to new conditions of competition.

Recent U.S. administrations, whether Republican or Democratic, have generally allowed the market to shift resources and workers out of declining industries, but this hands-off approach to restructuring has had its limits: when the political fallout from painful market-induced adjustments reaches a certain point, protectionist policies are all too often adopted that delay rather than promote adaptation. Japan has followed a different path, although not without internal dissension. Government, it is maintained, should facilitate the retrenchment of industries that are no longer internationally competitive, in part to minimize the economic disruption of the adjustment process and also because the major source of problems for these industries -- skyrocketing energy costs -- is not of their own making.

Government assistance to struggling industries has a long history in Japan. The major policy tool through the early 1970s was the recession cartel, which allows firms in an industry hit by a temporary reduction in demand to coordinate the cutback of production instead of waging a costly price war for sales -- the frequent response of Japanese manufacturers when markets shrink. In the wake of the first oil shock and the worldwide recession of 1974-75, however, Ministry of International Trade and Industry policymakers concluded that adjustment measures geared toward short-term drops in demand were no longer sufficient. Industrial casualties of the jump in energy costs (aluminum, electric furnace steel, paper and petrochemicals, to name just a few), as well as industries reeling from a long-run slide in demand (shipbuilding) or the loss of comparative advantage in labor-intensive products (textiles), required different, more comprehensive adjustment policies, MITI officials argued, since these industries were permanently saddled with excess capacity.

The ministry's solution was the Law on Temporary Measures for Stabilization of Specific Depressed Industries, passed by the Diet in May 1978 for a five-year period. This measure was not designed to phase out Japan's declining industries as some in the United States have described it. If anything, the objective was the exact opposite: to help troubled industries regain competitiveness or at least viability by speeding the elimination of excess capacity through coordinated cutbacks.

To this end, firms in industries designated as structurally depressed were granted antitrust immunity to reduce surplus capacity in line with plans worked out by MITI (or the relevant ministry) and its advisory group, the Industrial Structure Council. These restructuring plans contained forecasts of industry demand and supply, from which MITI calculated the amount of capacity that had to be decommissioned to clear the market as well as how much surplus plant and equipment should be scrapped and how much mothballed.

Manufacturers of 14 products spanning six industries eventually reduced capacity under the 1978 law -- shipbuilding, steel (ferrosilicon and electric furnace steel), nonferrous metals (primary aluminum), chemicals (ammonia, urea and phosphoric acid), paper (corrugated cardboard), and textiles (four types of synthetic fibers plus cotton and wool yarn) -- decommissioning roughly 95 percent of the aggregate plant and equipment targeted for disposal. Despite this near-perfect score, Japan's Fair Trade Commission and other domestic

The JEI REPORT (ISSN 0744-6489) is published weekly for $40 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Second class postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036.

critics of government involvement in the adjustment process claimed that the depressed industries program was ineffective in helping sunset industries. Cutbacks in capacity were the result of market pressures, not MITI's plans, they maintained. Perhaps more telling was their observation that none of the industries covered by the law had overcome its problems; some managed to operate in the black for brief periods of time, but not even these industries had really turned the corner on profitability.

MITI actually used the continued financial problems of Japan's declining industries to its own advantage. Arguing that the 1979 oil crisis and the deep economic slump of 1980-82 had set back the timetable for restructuring, the ministry persuaded the Diet in May 1983 to renew the depressed industries law for another five years. The goal of the new legislation -- renamed the Law on Temporary Measures for Structural Adjustment of Specific Industries to signify its claimed compatibility with the international concept of positive adjustment policy -- remains unchanged: to restore the viability of troubled industries. Where the 1983 measure differs from its predecessor is in its implicit acknowledgement that the elimination of uncompetitive operations is necessary but not sufficient for restructuring; rationalization and modernization must be coupled with contraction.

The law therefore puts new weight on the achievement of economies of scale through joint purchasing, production, sales, storage, transportation and/or distribution arrangements among firms within a depressed industry; division of production or markets is also promoted, as are mergers. Equal emphasis is placed on cooperative research and development efforts in such areas as energy and raw material cost reduction, product quality improvements, and new product and process technologies. MITI had hoped to give collaborative activities, especially business tie-ups, an extra boost by winning antitrust immunity for them, but the FTC blocked this move. As a result, MITI must get clearance from the antitrust agency before approving business tie-ups, although joint disposal of surplus plant and equipment remains exempt from Japan's Anti-Monopoly Law.

While MITI lost the fight for broader antitrust immunity for troubled industries, it did win the battle for greater support from the Finance Ministry. The only financial incentive included in the 1978 law was a loan guarantee fund designed to ease the problems of scrapping plant and equipment that had been pledged as collateral for bank loans. In addition to extending the life of this fund, the new legislation makes available low-cost loans from the government-backed Japan Development Bank for underwriting the introduction of new technologies or the installation of more efficient plant and equipment; these funds can be used as well to cover the disposal of excess capacity. The law's twin aims of contraction and modernization are also encouraged through the tax system. Companies, for example, can carry forward losses from writing off scrapped equipment for up to ten years and receive an additional 18 percent depreciation allowance in the first year on approved investments. Moreover, the government will subsidize half of the cost of selected R&D projects -- an undertaking expected to amount to Y6 billion ($25 million at Y240=$1.00) in FY 1985. What the legislation does not provide are direct operating subsidies for companies in declining industries; they must cover the cost of production or suffer the bottom-line consequences.

Despite the broader thrust of the 1983 law, the mechanics of the legislation are an extension of the earlier measure. For an industry in trouble to be designated as structurally depressed, a majority of its companies must be operating in the red and two-thirds must agree to participate in a restructuring program. Once these qualifications are met, MITI maps out an industry improvement plan in consultation with the Industrial Structure Council. The plan stipulates how much excess capacity should be decommissioned (although there is now no breakdown between scrapping and idling), as well as the steps the industry should take to achieve viability, like energy conversion, joint operations in specific areas or the use of more efficient equipment. MITI has the right to place restrictions on new investment if it suspects industry members will circumvent the capacity-reduction target by replacing scrapped production lines with new equipment. It also has the option to instruct companies to form a cartel when there are indications that the industry might not otherwise implement the contraction part of its plan.

Plans have been worked out under the 1983 legislation for manufacturers of 26 products, including 11 holdovers from the old law (see Table 1). The same basic materials industries previously covered show up on the new list, but a broader cross-section of their output is generally represented this time. From chemicals come ethylene, polyolefins and four other petrochemical products, plus compound fertilizers and a fourth fertilizer ingredient. A fifth type of synthetic fiber is included in the textiles industry, while paper joins corrugated cardboard in that industry. Primary aluminum remains the only representative of the nonferrous metals industry, but steel industry coverage now extends to three ferroalloy products and electric line and cable, as well as electric furnace steel. Joining these five industries on the roll of designated declining industries are two first-timers -- cement and sugar.

Does Government Involvement Make a Difference?

While MITI policymakers are understandably quick to argue that government assistance to declining industries makes the adjustment process faster and more efficient, this view is shared by few economists. The Fair Trade Commission's economics department is certainly not alone in maintaining that the retrenchment of Japan's problem industries has been triggered by the market. For proof, these critics say, MITI need only look at ammonia and ferrosilicon, where capacity has been cut by more than the targeted amount and well ahead of schedule, or at primary aluminum, where capacity reduction preceded final approval of a restructuring plan.

Economists also point out that government-orchestrated capacity cutbacks allow inefficient producers to continue to exist, thereby delaying real adjustments. A market-directed reduction in plant and equipment should eliminate the least efficient production units, but because compromise is needed to win industry backing for a restructuring plan, inefficient manufacturers are given an extended lease on life, particularly if they have only one production unit. Contraction in the electric furnace steel industry, for example, has been hindered by the large number of single furnace operators, most of which would be forced out of business if they had to scale back capacity. Conversely, economists add, the concept of shared sacrifice can force manufacturers to decommission efficient units of production.

Moreover, analysts question the relevance of a program based largely on capacity shrinkage for products that have lost their international competitiveness because of Japan's high electricity costs. While a smaller operating base might provide some short-run relief to energy-intensive industries like aluminum, electric furnace steel and ferroalloys, these industries require technological breakthroughs in production for long-term survival or, barring that, huge rate subsidies. Since the first scenario is not at all certain to materialize and the second has been rejected by Tokyo, many industry observers suggest that the government should phase out energy-intensive industries that will never again be viable instead of trying to cushion their decline.

Doubts have also been expressed about the effectiveness of the depressed industries law in resolving problems caused by slumping demand or high labor costs. Shipbuilders cut capacity by 35 percent under the 1978 law, but the industry's financial condition continued to deteriorate in line with the slow pace of new orders. With no upturn in business in sight and a price war sweeping the industry, the Ministry of Transportation finally issued two-year operating rate guidelines for shipyards in April 1983, subsequently extending its recommendations through March 1987. Similarly, the cotton spinning industry, another dropout from the government's program, has only managed to remain in the vicinity of the break-even point by voluntarily reducing capacity and limiting production.

To the list of reservations about the efficiency and effectiveness of Japanese adjustment policies can be added the question of just how much influence the government has over the activities of declining industries. Some of the country's least competitive industries -- plywood, for example -- have remained outside the program, although a number of these holdouts, including plywood, fall under the jurisdiction of the Agriculture Ministry rather than MITI.

Not that MITI has a perfect batting record in other areas. It has failed to persuade the top producer of electric furnace steel to join the restructuring plan for that product and to secure the participation of the leading maker of corrugating medium in the capacity-reduction program for cardboard. The ministry has also been unable to deter companies in some declining industries from investing in additional facilities. Electric furnace steel makers expanded net capacity by 28.5 percent under the 1978 law, and paper mills continued to invest in new plant and equipment while a restructuring plan was being worked out for them. Paper producers, in fact, have been authorized to form a cartel to ensure compliance with the contraction part of their restructuring plan; so have manufacturers of corrugated cardboard, compound fertilizers, ethylene, polyolefins, polyvinyl chloride and cement.

The View from Washington

Doubts like these do not pervade the U.S. government's evaluation of Tokyo's policies for declining industries. In the words of Lionel H. Olmer, former under secretary of Commerce for international trade, the role of the Japanese government in the restructuring process is "crucial, pervasive and determinative." The Reagan administration is equally convinced that the depressed industries program is inherently import restrictive -- even though none of the industry plans contain formal restrictions on imports.

At the heart of this belief is the view that the various collaborative arrangements sanctioned by the depressed industries law enable Japan's high-cost manufacturers to keep price-competitive imports out of the market. How else can the low level of import penetration in most problem industries be explained, ask U.S. trade officials. When their Japanese counterparts cite the big and expanding volume of foreign aluminum ingot and petrochemicals flowing into the country as evidence that government help for declining industries does not preclude imports, Americans reply that imports would be even greater were it not for this assistance.

To some extent, the opposing positions of U.S. trade officials and business analysts on the issue of the effectiveness and efficiency of Japanese government involvement in the restructuring process reflect the divergent experiences of industries affected by this process. As the case studies that make up the second part of this two-part report will illustrate, capacity cutbacks have failed to stem the long-term decline of some basic materials industries but have brought supply sufficiently close to demand in others to stabilize the market temporarily.

For further information, contact Susan MacKnight.

* * * * * *

The views expressed in this report are those of the author and do not reflect those of the Japan Economic Institute.

Table 1: Plans for Disposal of Excess Capacity

(in metric tons)

Industry/Product	Date Plan Approved	Capacity To Be Decommissioned	Percent of Capacity Affected	Target Date for Completion	Capacity Decommissioned Through June 1985			Percent of Target
					Total	Scrapped	Mothballed	
Petrochemicals								
*Ethylene	6-17-83	2,290,000	36%	3-31-85	2,020,000	981,000	1,039,000	88%
*Polyethylene and Polypropylene	6-17-83	900,000	22	6-30-85	850,000	338,000	512,000	94
*Polyvinyl Chloride	6-17-83	490,000	24	3-31-85	450,000	424,000	26,000	92
*Ethylene Oxide	8-30-83	201,000	27	6-30-85	122,000	122,000	0	61
*Styrene Monomer	1-29-85	468,000	26	9-30-85	240,000	100,000	140,000	51
*Rigid PVC Pipe	8-30-83	116,000	18	3-31-84	116,000	115,000	1,000	100
Chemical Fertilizers								
Ammonia	5-24-83	660,000	20	6-30-86	844,000	584,000	260,000	128
Urea	5-24-83	830,000	36	6-30-86	698,000	698,000	0	84
Phosphoric Acid (wet process)	5-24-83	130,000	17	6-30-86	81,000	66,000	15,000	62
*Fused Phosphate	6-17-83	240,000	32	6-30-87	112,000	39,000	73,000	47
*Compound Fertilizers	6-17-83	810,000	13	6-30-87	522,000	419,000	103,000	64
Synthetic Fibers								
Nylon Filament	5-24-83	**	--	--	--	--	--	--
Polyacrylonitrile Staple	5-24-83	**	--	--	--	--	--	--
Polyester Filament	5-24-83	**	--	--	--	--	--	--
Polyester Staple	5-24-83	**	--	--	--	--	--	--
*Viscose Staple	8-2-83	47,700	15	6-30-86	9,800	0	9,800	21
Paper and Pulp								
*Paper	10-7-83	950,000	11	9-30-86	381,400***	295,100	86,300	40
Corrugated Cardboard	5-24-83	1,537,000	20	6-30-87	858,000***	455,000	403,000	56
Aluminum Ingot	5-24-83	1,290,000****	79	3-31-86	930,000	n.a.	n.a.	72
Ferroalloys								
Ferrosilicon	5-24-83	50,000	14	6-30-86	56,800	10,400	46,400	114
*High Carbon Ferrochrome	1-29-85	57,000	10	6-30-86	0	0	0	0
*Ferronickel	1-29-85	51,000	12	6-30-86	0	0	0	0
Electric Furnace Steel	5-24-83	3,800,000	14	3-31-87	1,393,000***	408,000	985,000	37
*Electric Line and Cable	9-26-84	86,000	14	8-31-85	82,800	77,000	5,800	96
*Cement	2-5-84	30,000,000	23	3-31-86	24,652,000	24,652,000	0	82
*Sugar	9-27-83	1,000,000	26	9-30-86	630,000	n.a.	n.a.	63

*Industries or products not covered by the 1978 law on depressed industries.

**No additional capacity is scheduled to be decommissioned by makers of nylon filament, polyacrylonitrile staple, polyester filament and polyester staple, which were covered by the 1978 law. The time limit on capacity expansion, however, was extended to June 30, 1986.

***Data as of May 1985 for paper, March 1985 for corrugated cardboard and March 1985 for electric furnace steel.

****Aluminum ingot capacity, which had already been reduced by 530,000 metric tons by the time the 1983 law went into effect, was originally targeted to be cut by an additional 410,000 metric tons under the new law. In March 1985, however, another 350,000 metric tons of capacity were targeted for disposal, for a cumulative cutback of 2,290,000 metric tons.